

**DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK  
MULTILATERAL INVESTMENT FUND**

**COLOMBIA**

**STRENGTHENING CAPITAL MARKETS**

**(TC-01-09-02-2)**

**DONORS MEMORANDUM**

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## ANNEXES

### ANNEX I      Logical Framework

## **ABBREVIATIONS**

BVC	Bolsa de Valores de Colombia
CESI	Committee on Environment and Social Impact
DECEVAL	Depositorio Central de Valores
DTF	Depósito de Término Fijo (Colombian Interbank Offer Rate)
GDP	Gross Domestic Product
GOC	Government of Colombia
IDB	Inter-American Development Bank
MIF	Multilateral Investment Fund
SV	Superintendencia de Valores (Colombian Securities Exchange Commission)

## Strengthening Capital Markets in Colombia

(TC-01-09-02-2)

### EXECUTIVE SUMMARY

<b>Executing agency:</b>	Bolsa de Valores de Colombia, S.A. (BVC)		
<b>Beneficiaries:</b>	Beneficiaries of the project include: (i) the Bolsa de Valores de Colombia (the primary beneficiary) which will improve its systems for trading securities (especially as related to clearances and settlement), be able to offer new traded derivative instruments, and see increased transactional volumes as capital markets develop; (ii) financial intermediaries, which will be better able to hedge risks and offer new products; (iii) investors (individual and institutional) who will have better access to information and which will have significantly reduced levels of trading risk; and (iv) those firms and entrepreneurs which seek to raise funds or hedge risks on traded markets who, by working in improved information and corporate governance environments, should over time, experience better access to traded equity and hedging markets.		
<b>Amount and source:</b>	Modality:	Grant	TC Facility
	MIF:	US\$	1,018,300
	Local counterpart funding:	US\$	1,018,300
	Total:	US\$	2,036,600
<b>Terms:</b>	Execution Period:		36 months
	Disbursement Period:		42 months
<b>Objectives and Description:</b>	<p>The general objective of the proposed project is the strengthening of Colombian capital markets vis-à-vis the Bolsa de Valores de Colombia (BVC). This will be accomplished by supporting the BVC's efforts in the following areas.</p> <p><i>Information Disclosure and Corporate Governance:</i> The Program will support the creation of a data warehouse containing financial market and individual firm data for the use by investors (this would include improving disclosure standards) and support for BVC's efforts to protect investor interests through the dissemination of corporate governance requirements based on international standards. The data warehouse will include historical information from the three stock exchanges that merged to form the BVC and current information regarding traded instruments.</p>		

Current information availability will be evaluated and procedures will be established to ensure that information availability is consistent with international standards. Moreover, the access to information by market participants will be eased. Corporate governance standards will be reviewed and recommendations will be made on how to move to international standards. A pilot plan for corporate governance will be implemented with selected firms as part of a dissemination campaign directed at the investing public on the value of improved corporate governance.

*Clearance and Settlement:* The Program will provide an increased level of security of Colombian capital markets through the establishment of a clearance and settlement corporation that would guarantee all trades. Current systems will be evaluated and new systems will be established to affect payment on a net basis in accordance with international standards. The level of capital needed for a settlement guarantee fund, to allow the exchange to become the counterpart for all transactions will be determined. The clearance and settlement institution will be established and made operational (the associated guarantee fund will be privately funded).

*Derivatives Exchange:* Support for the design of operating guidelines and the establishment of trading systems needed for a proposed derivatives exchange in Colombia. This will include a review and reformulation of current derivative products traded in Colombia, the redesign of the derivatives trading platform, the development of new products along with clearance and settlement systems and the determination of required capitalization levels for a derivatives exchange. The project will include the development of software, design of security systems, risk management, and the definition of the interconnection requirements for brokers and other intermediaries.

**Environmental/  
social review:**

The Committee on Environment and Social Impact (CESI) reviewed and approved this project on December 14, 2001.

**Special  
contractual  
conditions:**

An operational plan and corresponding disbursement schedule for the first six months of activities must be presented prior to the first disbursement. A project administrator must be hired prior to the first disbursement.

**Exceptions to  
Bank policy:**

None

## **I. COUNTRY AND PROGRAM ELIGIBILITY**

- 1.1 Colombia was declared eligible for all forms of financing from the Multilateral Investment Fund (MIF) on October 29, 1993. This initiative is considered eligible through the Technical Cooperation Facility, as it will seek to improve the functioning of the financial sector by accelerating the development of capital markets in Colombia. Furthermore, capital market development was specifically identified as an area for future concentration by the MIF Working Group.<sup>1</sup>

## **II. BACKGROUND**

### **A. Capital markets in Colombia**

- 2.1 Capital markets in Colombia do not exhibit the level of development that is commensurate with the country's level of economic development. In the year 2000, market capitalization only represented 1.33% of GDP, significantly lower than other Latin American countries (Argentina, 3.42%; Brazil, 16.0%; Chile 9.32%; Mexico 7.19%; and Peru, 4.2%). Most transactions on the stock exchange are related to trading of government bonds and other fixed income instruments. The reasons for the lack of development are multiple, but they include deficiencies in clearance and settlement systems and a lack of market transparency (poor information dissemination, weaknesses in accounting and auditing standards, and poor corporate governance standards, especially by closely held firms).
- 2.2 The lack of depth in capital markets is reflected by in both the supply of investment securities by Colombian firms and the demand by investors (individual and institutional). Many firms do not look to capital markets as a sources of financing, while local investors (including private pension and unemployment funds) tend to concentrate investments in government paper and corporate bonds. As the Government of Colombia (GOC) follows through on its stated goal of reducing indebtedness, opportunities for enhanced capital market activity will develop, but these will only have a limited chance for success, if the underlying risk reducing structures, normally associated with capital markets are not addressed.
- 2.3 Traded capital market instruments in Colombia remain concentrated in bonds and bond-like instruments. Equity markets are very thin, accounting for only 0.4% of all trading activity. Total trading of capital market instruments in Colombia has

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<sup>1</sup> MIF Working Group Strategy Document (MIF/GN-56)

steadily increased over the last several years. From January 1999 to December 2001, average daily trading volume has increased from just under 500,000 to 1,800,000 contracts per day. The vast majority of the increase in trading activity has resulted from trading in government bonds, which increased from 205,000 to 1,242,000 transactions. This is followed by bank CDs, which increased from 205,000 to 468,000 over this same period. Over this period, average daily trading volume for corporate bonds increased from 45,000 to 81,000 while daily trading in equities decreased from 10,000 to 7,200.

- 2.4 Clearance and settlement is effective 3 days after the trade takes place (at international standard). This is facilitated by the BVC and DECEVAL, but neither the BVC nor DECEVAL manage a guarantee fund that guarantees trades. The lack of such a guarantee would preclude participation in Colombian capital markets by many international institutional investors.
- 2.5 While 159 firms have shares listed on the exchange, trading and liquidity tends to be concentrated in less than 25 firms. 16 of these make up the quoted Colombian general share index. Even the trading of those equities that make up the general index tends to be fairly illiquid with significant interday volatility. The trading of bonds tends to be far more liquid, with more than 6,000 different bond issues. Liquidity is especially strong in government bonds due to a multi-year effort by the Government of Colombia to develop a government yield curve (which currently extends beyond 3 years for fixed rate securities and 7 years for inflation indexed securities). In addition, there is active spot trading of US dollar / Colombian Pesos contracts on the BVC. During January 2002, the average daily value of trading for all securities on the BVC ranged from US\$220 million to \$550 million.
- 2.6 In terms of derivatives, there is a rapidly growing market for standardized contracts on interest rate and foreign exchange futures. The contracts allow for hedging risk up to 6 months in the future. Since October 2000, when these contracts were first offered, they have grown to account for approximately 6% of total futures operations in Colombia. Nevertheless, while these are operated on margin basis (with the BVC setting the margin levels and facilitating settlement), the BVC does not stand as counterparty for any of the operations. This greatly increases the risk of trading and only a limited number of banks and brokers are allowed to trade on the market and many potential participants are excluded from hedging activities.

## **B. Recent developments in Colombian capital markets**

- 2.7 In July 2001, the three stock exchanges operating in Colombia completed a long planned merger in order to increase capacity and standardize operations. For many years they have been operating on an integrated basis, but the merger underlines their intention to modernize and eventually become more fully

integrated into global financial markets. This integration also builds on efforts by the government to improve the legal and regulatory framework of securities markets. Supported largely by technical assistance funded by the World Bank, the Colombian Securities Exchange Commission (*Superintendencia de Valores*) has undertaken an extensive strengthening over the past several years. The Superintendencia de Valores is considered highly professional and proactive in terms of capital market development.

- 2.8 The reform of the pension and unemployment funds in Colombia have provided an increasing source for long-term investment that could conceivably form a base for active and longer term traded financial instruments. Nevertheless, due to a heavy penalty on plan sponsors for deviating from the returns of the average portfolio and the practice of benchmarking minimum investment returns to a portfolio dominated by short term interest rates, pension funds have been reticent to invest in equity or longer term debt securities. A large and growing percent of pension fund investment has been concentrated in short to medium term government bonds. Thus, the Bolsa de Valores de Colombia's activities are also concentrated in the trading of government bonds. As the Government's stated plan is a reduction in the real level of government debt, this, together with the projected reform of the private pension system, could provide an impetus to the expansion of equity and corporate bond markets.

### **C. Strengthening Colombian capital markets**

- 2.9 The proposed program is designed to strengthen Colombia's capital markets by addressing some of the critical structural and informational bottlenecks. First, the Program will work to improve information disclosure and establish more effective requirements for corporate governance for all firms that are traded on the Bolsa de Valores de Colombia. Improved corporate governance and greater market transparency would increase confidence in market institutions and the price formation process that is central to market activity. Second, the Program will support the creation of a modern clearance and settlement system. This should reduce significantly the operational risk associated with trading on the Bolsa de Valores de Colombia and make markets more transparent and thereby improve the price formation process that is central to capital market activity. Finally, the Program would support the development of a trading platform for derivative instruments. Derivatives markets provide hedging instruments to help firms better manage financial risk and to allow for a more efficient allocation of risk amongst economic agents.
- 2.10 The program is consistent with the Bank's efforts in Colombia. In terms of financial markets, past Bank programs have concentrated on the rationalization and supervision of the banking system, but goals include improved transparency and corporate governance, moving towards international accounting standards, and the further development of private pension and insurance markets. A strong stock market will support all of these efforts. Moreover, it is expected that the BVC will play a critical role as a private sector spokesman for these efforts.

- 2.11 The Bank Group (including the MIF) have limited experience in support of programs similar to the present proposal. Much of the Bank/MIF's work in supporting capital market development has been on the legal and regulatory side. Stock exchanges have been supported in specific settings including the development of a number of small exchanges in Central America and the harmonization of clearance and settlement systems in Central America and the Caribbean. There has not been a comprehensive evaluation of these programs for smaller countries. Neither of these programs is comparable to that proposed by the BVC, as it is a much larger, more developed exchange that has been in operations for decades. The Bank Group has also supported a successful modernization of clearance and settlement systems in Mexico and has recently worked to modernize the trading structure in Argentina. It is still too early to measure the impact of these programs. This Program is consistent with other Bank Group attempts to strengthen capital markets as it addresses structural issues, risk reduction, market transparency, and corporate governance elements.

### **III. PROGRAM OBJECTIVES AND BASIC COMPONENTS**

- 3.1 The general objective of the proposed project is the strengthening of Colombian capital markets vis-à-vis the Bolsa de Valores de Colombia (BVC). This will be accomplished by supporting the BVC's efforts in the following areas.

#### **Component 1: Information Disclosure and Corporate governance (US\$633,900)**

- 3.2 The program would support the development of capital market activity through a greater level of information disclosure (improving market transparency) and a private sector lead campaign for supporting the transition to international standards of Corporate Governance for firms that are being traded on the Bolsa de Valores de Colombia.
- 3.3 On the Corporate Governance front, the Program will support: (a) an evaluation of corporate governance practices among existing issuers; (b) the formulation of recommendations to resolve any deficiencies in corporate governance standards and a strategy to implement these recommendations; (c) the implementation of a pilot program for improved corporate governance among a selected group of issuers; and (d) the preparation of a dissemination program regarding the benefits of improved corporate governance. The latter would include a large national Congress of Corporate Governance wherein presidents of the approximately 250 firms that are inscribed in the BVC would be invited, and specific training programs for issuers throughout Colombia (covering approximately 150 people in Bogotá, 100 in Medellín, 80 in Cali, and 50 each in Barranquilla and Bucaramanga).

- 3.4 For the creation of the "Data Warehouse", MIF support would assist in: (a) the design and creation of the data warehouse and the initial information gathering (b) the analysis of current information and information flows within the BVC and proposals for optimization of existing flow plus the creation of new systems for providing information at international levels; (c) the design development and implementation of information systems to provide users with needed data flows; (d) organization of data into well structured relational data bases; (e) the creation of processes that will assure that market information is adequate for investment decision process; (f) analysis and redesign of indices; and (g) the design of analysis tools that can be accessed by all market agents.

### **Component 2: Clearance and Settlement (US\$297,800)**

- 3.5 The Program will support the creation of a Clearance and Settlement Corporation that would guarantee all trades that take place on the Bolsa de Valores de Colombia<sup>2</sup>. This will be accomplished through a comprehensive work program that would implement a modern Clearance and Settlement system within the Bolsa de Valores de Colombia (including design of the clearance and settlement function, coordination of the payment mechanisms, and the determination of the financial requirements for the fund used to guarantee transactions.) These will, to the extent that they are publically available, build on diagnostics prepared by the World Bank and other international bodies.
- 3.6 The Program would also support the development of operational guidelines for the clearing process. These will be compatible with international standards<sup>3</sup>. Training courses would also be designed and implemented for the staff of the Exchange and of the Settlement Corporation and be offered in Bogotá, Medellín and Cali. Finally, funds would also be used to design and implement the communications network that would be needed for the clearing and settlement process.
- 3.7 It is important to note that the project would not cover the cost of capitalization of the Settlement Corporation (the financial structure that would be used to guarantee settlement). These funds would come from the BVC and member institutions.

### **Component 3: Creation of a Derivatives Exchange (US\$612,000)**

- 3.8 The Program would support the creation of a modern financial derivative exchange. This would include the operational design and the effective

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<sup>2</sup> The existing depository (Deceval), partially owned by the BVC, is involved in clearance and settlement, but the current structure is considered flawed as there is no clear counterpart that guarantees trades. It is not clear if a new clearing corporation will be created, or if Deceval will be restructured. This will depend on the recommendations of the consultants and sources of capital for the guarantee fund.

<sup>3</sup> See Committees on Payments and Settlements Systems, "Recommendation for Securities Settlement Systems," Technical Committee of the International Organization of Securities Commissions, November 2001 ([www.bis.org/pub/cpss86.pdf](http://www.bis.org/pub/cpss86.pdf)).

establishment of the derivatives exchange. This would include the determination of margin requirements and the required capitalization of the derivatives exchange (initial and increases as trading volume grows). Appropriate risk management controls, including a coordinated approach to settlement between spot and futures markets, will be included in the design and implementation. The Program would finance the hardware and software needed to set up the trading and clearing systems. Training for the personnel of the exchange would be developed and implemented. Finally, funds would be used to educate participants in Colombian financial markets on the benefits and risks of a derivative exchange.

- 3.9 The derivative exchange would initially deal with futures and options contracts on the peso-dollar exchange rate and peso interest rates. Options and futures on a Colombian stock index options and other hedging instruments for equity investors might be developed in the future if there is sufficient demand.
- 3.10 As in the case of the Clearance and Settlement Corporation, MIF funds would not be used to capitalize the exchange nor to establish needed guarantee funds. The eventual shareholders of the derivative exchange would provide these funds.
- 3.11 The specialized expertise for the evaluation, design and implementation of each of these three components likely resides with existing exchanges and clearance and settlement corporations. The BVC intends to rely heavily on these institutions for the needed consulting services. The cost of each component has been carefully calculated based on (a) the experience of the BVC in undertaking similar programs in the past and (b) the recent experience of other exchanges that have undertaken similar restructuring programs in these areas.

#### **IV. EXECUTING AGENCY AND BENEFICIARIES**

##### **A. Execution structure**

- 4.1 The proposed program will be executed over a three-year period (36 months of execution and 42 months for disbursements), and the Bolsa de Valores de Colombia (BVC) will be the grant beneficiary and responsible for local counterpart resources. The BVC is a private corporation that was created in June 2001, as a result of the merger among the three stock exchanges operating in Colombia (Bolsa de Bogotá, Bolsa de Medellín and Bolsa de Occidente). It is tasked with maintaining an orderly market for publicly traded investment securities in Colombia, allowing price formation to take place in an orderly and transparent market. It also operates as a self-regulatory organization, as a rule setting body for securities transactions and ensuring compliance with these trading and listing rules. The BVC is also responsible for providing information to the public regarding the price formation process. While only formed this year, the three antecedent organizations have undertaken these same basic functions for decades. The BVC has strong professional and technical management and is well

respected in the region. It is supervised by the Superintendencia de Valores (SV), the Colombian securities exchange commission. It should be noted that the SV is aware of and supportive of the BCV's efforts in all three components and will closely monitor the project during implementation.

- 4.2 The BVC has amply demonstrated its capacity to execute complex projects. They have jointly worked in (i) the establishment of a joint electronic trading system for both corporate and government debt instruments; (ii) the establishment of a term market for financial compliance (based on derivatives on the representative dollar-peso rate and the DTF interest rate); (iii) the creation of a public debt market; (iv) the creation of a central depository; (v) the establishment of a system to administer guarantees that back up securities trading; (vi) providing support for the democratization of the holdings for some of the largest firms in Colombia; and (vii) the development of a website and news agency that operates through the website.
- 4.3 The BVC is uniquely qualified to undertake this project. The leadership of the Exchange in capital market activities will allow it to set the tone for all three components of the program. The management is considered professional and is well regarded with in Colombia and internationally. The President of the Bolsa was recently elected to a two-year term as president of the Ibero-American Association of Stock Exchanges.
- 4.4 The senior management of the BVC will supervise the execution of the project activities, in accordance with the terms and conditions agreed with the Bank. They will be responsible for hiring the needed consultants and will supervise the technical quality of the work. The BVC will hire a project administrator to oversee and coordinate the execution of the project, and who will report to senior management. It is expected that this individual will supervise the contracts and coordinate closely with the IDB representative office in Colombia on eligibility, procurement and disbursement issues. Given the specialized nature of the work, it is expected that the key activities will be contracted to other stock exchanges that are familiar with the region and have experience in similar reform projects. The BVC has proposed a very tight time frame for completing the project, but recognize that there may be some unavoidable delays in the contracting process due to the limited number of entities that are qualified to undertake some of the key components.
- 4.5 The BVC will establish and maintain adequate accounting, financial, internal control, and filing systems, which will allow the identification of sources and uses of funds of the program. The accounting system will be organized to provide necessary documents, permit verification of transactions, and facilitate the timely preparation of financial statements and reports. The project's records will be kept in a way that: (i) identifies sums received from different sources; (ii) reports project spending in accordance with a chart of accounts previously approved by the Bank, distinguishing between MIF contributions and funds from other sources; and, (iii) includes details necessary to identify goods acquired and

services contracted, as well as the use of those goods and services. The BVC will also open separate and specific bank accounts for the administration of the MIF's contribution, and for the local counterpart funds. Finally, the BVC will process the disbursement requests and their respective justifications of expenditures, in accordance with the Bank's disbursement procedures; and, prepare and submit to the Bank the project's final audited financial statements and the revolving fund's semi-annual reports.

- 4.6 **Revolving Fund.** After having completed all the conditions prior to first disbursement, a revolving fund of up to 15% of the grant may be made if the executing agency so requests. The amount for the revolving fund has been recommended by the project team and deemed justifiable due to the expenses that will be incurred at the initiation of this project. The BVC will prepare and submit to the Bank, within a period of thirty (30) days after the closing of each semester, a semiannual report showing the status of the revolving fund as of June 30 and December 31. Disbursements of grant funds and the purchase of goods and services will be done in accordance with Bank/MIF procedures
- 4.7 **Financial Audits.** The BVC will prepare and submit to the Bank, within ninety (90) days after the final disbursement of the project, a final financial statement regarding the Bank's contribution and local counterpart funds. A firm of independent auditors acceptable to the Bank will audit these financial statements. The audit costs will be financed with proceeds from MIF's contribution, in accordance with the Bank's procedures
- 4.8 **Supervision.** The IDB Country Office in Colombia will be responsible for supervising this technical cooperation. The BVC will submit to the Country Office all project progress reports within 30 days after the completion of each semester and a final report within 30 days from the last disbursement. These reports will follow a previously agreed to format and will address project activities, finances and results. In addition, the Country Office will be charged with providing a report three months after project completion, indicating the results of the project. The Project Team will work closely with the Country Office on the technical issues regarding the execution of the project.

## V. COST, SOURCE OF FINANCING AND COST RECOVERY

**Table 5.1**  
**Strengthening Capital Markets in Colombia**

BUDGET CATEGORIES	MIF	LOCAL	TOTAL	%
Component I: Corporate Governance and Information Disclosure	338,400	295,500	633,900	31.1
Component II: Clearance and Settlement	145,000	152,800	297,800	14.6
Component III: Creation of a Derivatives Exchange	342,000	270,000	612,000	30.1
Project Administration	0	200,000	200,000	9.8
Evaluation, Audit and Dissemination of results of Program	149,000	0	149,000	7.3
Contingencies	43,900	100,000	143,900	7.1
<b>TOTAL</b>	<b>1,018,300</b>	<b>1,018,300</b>	<b>2,036,600</b>	<b>100.0</b>

- 5.1 The cost of the program is estimated at US\$2,036,600 of which the equivalent of US\$1,018,300 will be provided by the MIF (Technical Cooperation Facility) on a non-reimbursable basis, and the equivalent of US\$ 1,018,300 will be provided by the BVC as local counterpart funding in accordance with the preceding table. The majority (80%) of the BVC's contribution will be in cash (excluding project administration 86% of the contribution will be in cash).
- 5.2 **Sustainability.** The sustainability of the program depends on the ability of the Bolsa de Valores de Colombia to undertake the reforms and therefore be perceived as a more attractive option for intermediation. Therefore, the project is expected to achieve sustainability by creating a conducive environment for increased capital flows through enhanced transparency and providing market assurance to investors. Furthermore, the innovative efforts of the BVC in providing private sector leadership within Colombia's financial markets, especially in the areas of market transparency and corporate governance along with the willingness of the BVC to disseminate this information to other countries of the region will have an impact that goes beyond the project. Demonstrating that these innovations can be successful in one of the mid-sized economies of the region should encourage other countries to adopt similar reforms.

## **VI. BENEFITS AND RISKS**

### **A. Benefits**

- 6.1 The project is expected to achieve the following results including:
- a. The improvement of corporate governance standards and information disclosure requirements should reduce risks for minority shareholders and institutional investors by increasing incentives for firm management to serve their interests. In addition they should help strengthen investor confidence regarding the price formation process.
  - b. The creation of a modern clearance and settlement system should increase the effectiveness of markets and reduce their operational risks.
  - c. The creation of a derivative exchange would enhance the ability of Colombian firms and investors to hedge risk and provide important price signals to markets regarding financial risk.
- 6.2 The proposed program for Strengthening Capital Markets in Colombia is expected to have a catalytic effect on the development of capital market activities in several ways. First, by improving the efficiency and security of trading systems (especially the clearing and settlement process), potential investors will be more willing to invest as there will be a greater assurance that trades will be completed as agreed. Second, by improving corporate governance, providing better and more timely information on traded firms and establishing standards for protecting the rights of minority investors, public confidence in the price discovery process should improve, as well as reducing the uncertainty regarding future valuation by building the basis of a market for corporate control. Third, the creation of more effective markets should help increase the supply of investment securities as firm owners and management should increasingly view capital markets as a secure source of investment funds. Finally, the development of a derivative exchange would help reduce risks associated with changes with interest and exchange rate movements (and eventually commodity price movements) and allow firms to concentrate on those areas where they have a comparative advantage.
- 6.3 The proposed program is highly innovative, particularly as it relates to the promotion of improved corporate governance within Colombia financial markets. The fact that a private sector entity, such as the exchange, is willing to take a leadership position within Colombia and champion the development of corporate governance standards is really exceptional. By placing a private sector face on this problem, the BVC can speak with moral authority regarding the need for transparency and corporate governance as a prerequisite for true capital market development. The proposed pilot program, which will support a small number of firms to demonstrate the impact of the adoption of international standards of conduct, is unique. The willingness of the BVC to disseminate information regarding its experience should support efforts to improve corporate governance

throughout the region. This demonstration effect will be particularly important for the medium sized economies of the region where capital market reforms are at an early stage.

## **B. Risks**

- 6.4 There are a number of risks to the project, arising both from the macroeconomic and macrofinancial situation of Colombia and from the difficulties of implementing a complex project.
- 6.5 First, there has been a significant level of capital flight (both human and financial capital) from Colombia over the past several years due to the deteriorating economic and security situation. Greater political and economic stability will be needed for capital markets to fully develop. Without these, the impact of the program will be lessened. This risk is viewed as similar to that of all financial sector operations in Colombia.
- 6.6 Second, with respect to the clearance and settlement systems and the development of the derivatives exchange, there will likely be the need for additional capital in the exchange (or the clearance and settlement corporation) to support the counterparty risk. The members of the exchange, especially some of the major banks, have indicated a willingness to provide this capital.
- 6.7 Third, some of the reforms, especially those related to improved concept governance, would ideally be backed up with the appropriate legal framework and enforcement. As previous efforts to enact laws have failed, the current proposal may face limits, but the private sector led attempt to establish standards and educate market participants is a strong step in the right direction. Even so, not all firms will chose to implant both the letter and the spirit of the reforms.
- 6.8 The BVC is taking a very aggressive approach to improving corporate governance for traded firms. There is not full agreement within Colombia for adopting a modern corporate governance program. This risk can only be mitigated by a combined effort of institutions such as the BVC, the Superintendencia de Valores (CNV), and the multilateral community.
- 6.9 **Beneficiaries.** Beneficiaries of the project include: (i) the Bolsa de Valores de Colombia (the primary beneficiary) which will improve its systems for trading securities (especially as related to clearances and settlement), be able to offer new traded derivative instruments, and see increased transactional volumes as capital markets develop; (ii) financial intermediaries which will be better able to hedge risks and offer new produces; (iii) investors (individual and institutional) who will have better access to information and which will have significantly reduced levels of trading risk; and (iv) those firms and entrepreneurs which seek to raise funds or hedge risks on traded markets who, by working in improved information and corporate governance environments, should over time experience better access to traded equity and hedging markets.

## **VII. PERFORMANCE INDICATORS AND EVALUATION**

- 7.1 The Bank will contract consultants to carry out a mid-term and final evaluation of the project. The mid-term evaluation will be prepared 12 months after project implementation or when 50% of the resources have been disbursed. A final evaluation will be conducted within three months after the project is completed.
- 7.2 During the project's execution, the BVC will compile supervision and project evaluation indicators. These indicators are set forth in the Logical Framework (see Annex I) and will be used by the Bank Country Office and the BVC to gauge the overall impact and to assess the results.
- 7.3 For the final evaluation, an independent evaluation expert will take into account the program's impact on potential market development as well as the degree to which the reform program resulted in the adoption on international standards. This final evaluation would focus on key areas such as: (a) the quality of information disclosure in Colombian capital markets; (b) the impact of the project in improvement of corporate governance among traded firms (including an evaluation of the quality of the ongoing debate on this topic); (c) the safety and soundness and the efficiency of the clearing and settlement process; (d) the design of derivatives exchange, the trading platform, and the level of capital committed to the derivatives exchange. The executing agency will provide access to all the information and documentation needed to conduct these evaluations.

## **VIII. EXCEPTIONS TO POLICIES AND PROCEDURES**

- 8.1 No exceptions to Bank policies are involved.

## **IX. SPECIAL CONTRACTUAL CONDITIONS**

- 9.1 An operational plan and corresponding disbursement schedule for the first six months of activities must be in place and the project administrator must be hired before the first disbursement.
- 9.2 **Status of preparation.** The design, budget and activities planned under the project have been prepared by the BVC with input from stakeholders and the Project Team. The local counterpart's contribution has been confirmed. Given its track record in the execution of other programs of similar magnitude, it is fully expected that the BVC will successfully execute the project within the expected timeframe.

## LOGICAL FRAMEWORK

OBJECTIVES	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<b>GENERAL OBJECTIVE</b>			
Enhanced use of Colombian capital markets for financing private sector activities.	Increased number of firms and investors active in the Colombian capital markets.	Report on trading volume and listing of equity and debt of private firms on the exchange.	Macroeconomic and legal stability. General business conditions will remain sound. Government will follow through on commitment to reduce the gross level of government debt.
<b>PURPOSE</b>			
Colombian capital markets operating in line with international standards in regards to corporate governance/ transparency and clearance/settlement; and preparations completed for the creation of a derivatives exchange.	Improved transparency and establishment of corporate governance standards;  Effective clearance and settlement taking place; and  Operational design and plan for the establishment of a derivatives exchange.	Existence and ready access by investing public to securities market data warehouse  Comparison with international standards  Presentation of plan	With greater transparency, individuals and firms will be better able to evaluate risk and make investment decisions. Capitalization of the clearance and settlement institution is provided.  The appropriate expertise can be hired and capital is made available.
<b>COMPONENTS</b>			
I. Corporate Governance and information disclosure.	Representatives from approximately 250 firms will be made aware of the benefits of better corporate governance leading to the improved corporate governance practices at a number of traded firms in Colombia; over 400 issuers will have received training related to corporate governance; information on corporate governance made more accessible to investors through the creation of a data warehouse.	Availability of investor information from the BVC (both printed and electronic);  Series of congresses, seminars and training programs provided;  Annual reports and reports by the BVC on Corporate Governance (written and on website).	Continued macroeconomic legal and political stability;  Private sector support;  Willingness of firms to participate.
II. Clearance and Settlement	Modern clearance and settlement systems will be functioning and all trades will be secure in that the BVC and/or settlement corporation guarantees them.	Existence of a new Clearance and Settlement Corporation and a report from the BVC noting the size of the guarantee fund and how all trades are being guaranteed.	Private sector capitalization for the guarantee fund.
III. Creation of a Derivatives exchange	Reformulated derivative instruments will be available and offered for trading in a new	Existence of the exchange.	Private sector capitalization of the exchange and demand for derivative

## LOGICAL FRAMEWORK

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	derivatives exchange.		instruments by investors and financial intermediaries.
<b>ACTIVITIES</b>			
<p>1.1 Recompilation of historical information of the three exchanges that formed the BVC.</p> <p>1.2 Establish uniform criteria, compatible format and present a unified database of historical information.</p> <p>1.3 Creation of improved processes for information availability.</p> <p>1.4 Automate information processes and provide information to users.</p> <p>1.5 Convert information generated by the trading systems into structures relational databases</p> <p>1.6 Create a system to analyze data and create indexes and design analytical tools.</p> <p>1.7 Undertake an evaluation of existing corporate governance practices and provide recommendations that resolve any deficits in current corporate governance practices.</p> <p>1.8 Design a strategy to implement these recommendations.</p> <p>1.9 Organize a pilot program on corporate governance with a group of current issuers, designed to evaluate the impact.</p> <p>1.10 Produce a report on the results of the pilot program.</p> <p>1.11 Organize a conference on benefit of improved corporate governance.</p> <p>1.12 Develop training programs on corporate governance.</p>	<ul style="list-style-type: none"> <li>- At a minimum, database would include information on prices, trading volume, and related indexes.</li> <li>- New process are at the level of international standards</li> <li>- Users are able to access information</li> <li>- Data base provides access to information in a useful manner</li> <li>- Market participants have access to information</li> <li>- Strategy is based on international best practices</li> <li>- A number of issuers agree to participate in the transition to corporate governance standards</li> <li>- Participation of 250 firms</li> <li>- Training programs provided in Bogotá, Medellín, Cali, Bucaramanga and Barranquilla (expect 250, 100, 80, 50 and</li> </ul>	<ul style="list-style-type: none"> <li>- Report on historical information</li> <li>- Consulting report</li> <li>- Presentation of evaluation and recommendations</li> <li>- Presentation of tested software working on hardware.</li> <li>- Presentation of relational data base</li> <li>- Report</li> <li>- Evaluation report</li> <li>- Presentation of strategy</li> <li>- Letter of Agreement with BVC</li> <li>- Letters of invitation and conference program/list of participants</li> <li>- Letters of invitation and conference program/list of participants</li> </ul>	

## LOGICAL FRAMEWORK

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	50 participated, respectively)		
2.1 Evaluate current system and propose a new settlement system that meets international standards. 2.2 Determine the level of capital needed in a guarantee fund and for the capitalization of the clearance corporation. 2.3 Determine the technological requirements for the clearance and settlement system. 2.4 Implement the new clearance and settlement system.	<ul style="list-style-type: none"> <li>- Proposals meet international standards</li> <li>- Capital and margin levels set in accordance with measures of risk to assure security of system</li> <li>- Based on proven technology</li> <li>- All trades guaranteed by exchange and new clearance and settlement corporation</li> </ul>	<ul style="list-style-type: none"> <li>- Consulting report</li> <li>- Consulting Report</li> <li>- Consulting report</li> <li>- Report from exchange/clearance and settlement corporation</li> </ul>	
3.1 Evaluate and reformulate existing derivative contracts. 3.2 Evaluate and recommend modifications to current trading systems. 3.3 Design new derivatives products. 3.4 Evaluate risk for the contracts and propose solutions to mitigate risks. 3.5 Determine the level of capital needed for the derivatives exchange and margin requirements. 3.6 Develop new trading system. 3.7 Create a clearance and settlement system for the derivatives exchange. 3.8 Implement the new system.	<ul style="list-style-type: none"> <li>- Reformulated contracts</li> <li>- Recommendations on trading systems</li> <li>- Product designs</li> <li>- Formula for determining capital and margin requirements</li> <li>- Existence of new trading system</li> <li>- Existence of new settlement system</li> <li>- Existence of functioning including interconnection with users (brokers, intermediaries, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>- Consulting report</li> <li>- Consulting report</li> <li>- Consulting report</li> <li>- Contract design</li> <li>- Report on Capital requirements and margin rules</li> <li>- BVC report on new trading system</li> <li>- BVC report on new settlement system</li> <li>- BVC Report</li> </ul>	